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Accounting for Intangible Assets

THIS bulletin deals with some of the problems involved in accounting for certain types of assets classified by accountants as intangibles, including those acquired by the issuance of securities as well as those purchased for cash. Such assets may be purchased or acquired separately at a specified price or consideration, or may be purchased or acquired, together with other assets, for a lump-sum price or consideration, without specification by either the seller or the purchaser at the time of purchase, of the portion of the total price which is applicable to the respective assets thus acquired. The bulletin does not deal with the problems of accounting for intangibles developed in the regular course of business by research, experimentation, advertising, or otherwise.

The intangibles herein considered may be broadly classified as follows:

(a) Those having a term of existence limited by law, regulation, or agreement, or by their nature (such as patents, copyrights, leases, licenses, franchises for a fixed term, and goodwill as to which there is evidence of limited duration).

(b) Those having no such limited term of existence and as to which there is, at the time of acquisition, no indication of limited life (such as goodwill generally, going value, trade names, secret processes, subscription lists, perpetual franchises, and organization costs).

(c) The excess of a parent company's investment in the stock of a subsidiary over its equity in the net assets of the subsidiary as shown by the latter's books at the date of acquisition, in so far as that excess would be treated as an intangible in consolidated financial statements of the parent and the subsidiary. This class of asset may represent intangibles of either type (a) or type (b) above or a combination of both.

The intangibles described above will hereinafter be referred to as type (a) and (b) intangibles, respectively.

SUMMARY STATEMENT

(1) The initial carrying value of all types of intangibles should be cost, in accordance with the generally accepted accounting prin-

ciple that assets should be stated at cost when they are acquired. In the case of non-cash acquisitions, cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident.

(2) The cost of type (a) intangibles should be amortized by systematic charges in the income statement over the period benefited, as in the case of other assets having a limited period of usefulness.

(3) The cost of type (b) intangibles may be carried continuously unless and until it becomes reasonably evident that the term of existence of such intangibles has become limited, or that they have become worthless. In the former event the cost should be amortized by systematic charges in the income statement over the estimated remaining period of usefulness or, if such charges would result in distortion of the income statement, a partial write-down may be made by a charge to earned surplus, and the balance of the cost may be amortized over the remaining period of usefulness. If an investment in type (b) intangibles is determined to have become worthless, the carrying value should be charged off either in the income statement or to earned surplus as, in the circumstances, may be appropriate.[1] In determining whether an investment in type (b) intangibles has become, or is likely to become worthless, it is proper to take into account any new and related elements of intangible value, acquired or developed, which have replaced or become merged with such intangibles.

(4) Where a corporation decides that a type (b) intangible may not continue to have value during the entire life of the enterprise, it may amortize the cost of such intangible despite the fact that there are no present indications of such limited life which would require reclassification as type (a), and despite the fact that expenditures are being made to maintain its value. In such cases the cost may be amortized over a reasonable period of time, by systematic charges in the income statement. The procedure should be formally approved, preferably by action of the stockholders, and the facts should be fully disclosed in the financial statements. Such amortization is within the discretion of the corporation and is not to be regarded as obligatory.

(5) There is a presumption, when the price paid for a stock investment in a subsidiary is greater than the net assets of such subsidiary applicable thereto, as carried on its books at date of acquisition, that the parent company, in effect, placed a value greater than

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[1] Other problems arising from partial loss of value of type (b) intangibles are not dealt with herein. See discussion, page 199.

book value on some of the assets of the subsidiary in arriving at the price it was willing to pay for its investment therein. If practicable there should be an allocation of such excess as between tangible and intangible property and any amount allocated to intangibles should be further allocated to determine a separate cost for each type (a) intangible and for at least the aggregate of all type (b) intangibles. The amounts so allocated to intangibles should thereafter be dealt with in accordance with paragraphs (1), (2), (3), and (4) hereof.

(6) In connection with the foregoing procedures, the committee recognizes that in the past it has been accepted practice to eliminate type (b) intangibles by writing them off against any existing surplus, capital or earned, even though the value of the asset is unimpaired. Since the practice has been long established and widely approved, the committee does not feel warranted in recommending, at this time, adoption of a rule prohibiting such disposition. The committee believes, however, that such dispositions should be discouraged, especially if proposed to be effected by charges to capital surplus.

DISCUSSION

In dealing with the intangible assets herein considered, important questions arise as to the initial carrying value of such assets, the amortization of carrying value where their term of existence is definitely limited or problematical, and the adjustment of carrying value where there is a substantial and permanent decline in the value of such assets. These questions involve basic accounting principles of balance-sheet presentation and income determination. The committee believes that the accounting for intangibles has heretofore been regarded as being of relatively minor importance; accounting practices with respect thereto have varied greatly. The present bulletin is designed to promote a fuller consideration of the relation of intangibles to income and earned surplus.

Initial Carrying Value

The committee has heretofore taken the position that the accounting for tangible fixed assets should normally be based on cost[2], which may be defined generally as the price paid or consideration given to acquire the asset in question. Attention is now directed to the fact that the same principle is applicable to intangibles.

The committee has considered two further problems which may arise in the determination of the cost of intangibles. Since intangibles are frequently acquired in exchange for securities, the com-

[2] Accounting Research Bulletin No. 5.

mittee points out that in the case of non-cash acquisitions cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident.

The second problem arises in cases where a group of intangibles or a mixed aggregate of tangible and intangible property is acquired for a lump-sum price or consideration. It is essential in such cases that an allocation of the aggregate cost be made as between tangible and intangible property, and it is manifestly desirable that the cost of intangibles be further allocated to determine a separate cost for each type (a) intangible so acquired and for the aggregate, at least, of all type (b) intangibles.

Amortization Accounting

The cost of tangible assets having a limited term of usefulness is dealt with by depreciation accounting, which the committee on terminology has defined as a system of amortization which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any), over the estimated useful life of the unit (which may be a group of assets) in a rational manner.[3] In like manner the cost of intangible assets having a limited term of usefulness should be dealt with under amortization accounting. To this end the committee has classified intangibles as between type (a) which includes those having a term of existence limited by law, regulation, or agreement, or by their nature; and type (b) which includes those as to which there is, at the time of acquisition, no evidence of limited life. The committee recognizes that there may be cases in which it is difficult to make such a classification.

The cost of intangibles classified as type (a) should be amortized by systematic charges in the income statement over the period benefited. If it becomes evident that the period benefited will be longer or shorter than originally estimated, recognition thereof may take the form of an appropriate decrease or increase in the rate of amortization or if such increased charges would result in distortion of the income statement a partial write-down may be made by a charge to earned surplus.

The intangibles classified as type (b) may be carried continuously at cost unless and until it becomes reasonably evident that their term of existence has become limited, or that they have become worthless. In the former event they should be reclassified as type (a) and thereafter amortized by systematic charges in the income

[3] Accounting Research Bulletin No. 22.

statement over the estimated remaining period of usefulness. If that period of amortization is relatively short so that misleading inferences might be drawn as a result of the inclusion of substantial charges in the income statement, a partial write-down may be made by a charge to earned surplus and the balance of the cost may be amortized over the remaining period of usefulness.

In the event of complete loss of an investment in type (b) intangibles, a charge should be made either in the income statement or to earned surplus as, in the circumstances, may be appropriate.

In determining whether an investment in type (b) intangibles has or is likely to become worthless, consideration should be given to the fact that in some cases intangibles acquired by purchase may merge with, or be replaced by, intangibles acquired or developed with respect to other products or lines of business, and that in such circumstances the discontinuance of a product or line of business may not in fact indicate loss of value.

Partial Loss of Value

The committee recognizes that changes in general economic conditions and changes affecting the business of a particular company may have an important effect on the value, at a given time, of its intangibles. It further recognizes the difficulty of determining whether adverse changes are temporary or permanent. The problems arising as a result of such partial loss of value (as contrasted with total loss of value discussed above), which are also applicable to tangible assets (such as, loss of commercial value of tangible capital assets not covered by depreciation accounting), are not dealt with herein but are in their broader aspects presently under consideration by the committee. Attention is drawn however, to Rule No. 2, adopted by the membership of the Institute in 1934, which provides that "capital surplus, however created, should not be used to relieve the income account of the current or future years of charges that would otherwise fall to be made thereagainst."[4]

Discretionary Amortization of Intangibles

If a corporation decides to amortize the cost of a type (b) intangible, as to which there is no present indication of limited existence or loss of value, by systematic charges in the income statement, such procedure is permissible despite the fact that expenditures are being made to maintain its value. The plan of amortization should be reasonable; it should be based on all the surrounding circum-

[4] Accounting Research Bulletin No. 1, p. 6.

stances including the basic nature of the intangible and the expenditures being currently made for development, experimentation, and sales promotion. Where the intangibles are important income-producing factors and are being currently maintained by advertising or otherwise, the period of amortization should be reasonably long. The procedure should be formally approved, preferably by action of the stockholders, and should be fully disclosed in the financial statements. The committee believes that such amortization should be entirely within the discretion of the corporation and should not be regarded as mandatory.

Intangibles in Consolidation

Where a parent corporation has made a stock investment in a subsidiary, at a cost in excess of its equity in the net assets of the subsidiary as shown by its books at the date of acquisition, the parent corporation may have (a) paid amounts in excess of book value for specific assets of the subsidiary or (b) paid for the general goodwill of the subsidiary. If practicable, such an excess should be divided as between tangible and intangible assets, and the amount allocated to intangibles should be further allocated as between each type (a) intangible and the aggregate, at least, of all type (b) intangibles. The amounts so allocated should thereafter be dealt with in accordance with the rules hereinbefore set forth.

Write-off Where There Is No Evidence of Loss of Value

In adopting the procedures set forth above the committee recognizes that in the past it has generally been considered proper to eliminate the cost of type (b) intangibles from the accounts, in whole or in part, by a charge against any existing surplus, capital or earned, even though the value of the asset is unimpaired. Since the practice has been long established and widely approved, the committee does not feel warranted in recommending, at this time, adoption of a rule prohibiting such disposition. In addition the matter of charges to capital surplus requires further consideration and is part of the general problem of surplus accounting on the study of which the committee is presently engaged.

The committee believes, however, that such dispositions should be discouraged, especially if proposed to be effected by charges to capital surplus. It points out that the reduction of the investment, upon which the responsibility and accountability of management is based, may give rise to misleading inferences if subsequent earnings are compared with the reduced base.

Accounting for Intangible Assets

The statement entitled "Accounting for Intangible Assets" was adopted by the assenting votes of eighteen members of the committee, as it was constituted at the time of the 1944 annual meeting of the Institute. Mr. Willcox dissented. Mr. Stans dissented from paragraph (5) of the summary statement and the related discussion. Mr. Zebley dissented from paragraphs (5) and (6) of the summary statement and the related discussion.

NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3).